

UPDATE ON FICA WITHHOLDING ON EMPLOYEE PENSION CONTRIBUTIONS

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- On May 13, 2014, Two Area District Managers of the Internal Revenue Service (IRS) met with representatives of the Personnel Cabinet and the Finance and Administration Cabinet concerning the reporting of Social Security Tax liabilities by Kentucky's governmental employers.

PROBLEM – our calculation and reporting of Social Security tax liabilities and Medicare tax liabilities

Total wages

Less Employee's pension contributions

= Taxable FICA wages

CORRECT WAY - include the employee's pension contributions in the taxable wages.

HISTORY - Begin with Income Tax Benefit Change for Employees.....

In 1983, Congress and Kentucky passed legislation that under 414(h) of the United States Internal Revenue Code, removed state pension contributions from employee's gross income until such time they were distributed by the pension system.

This legislation exempted these payments if the employer through withholdings deducted and paid the pension contributions directly to the retirement system.

The legal term is **“picked up and paid”**

HISTORY – Next, FICA tax Benefit for Governmental Employees

In 1987, additional legislation was passed by Congress to exempt the pension system withholdings from Social Security tax, provided that such “picked up” payments were not made pursuant to a “salary reduction agreement”.

Congress did not define a salary reduction agreement.

IRS PRIVATE LETTER RULING-#8718032

From 1987 until present, governmental employers in Kentucky have calculated their FICA tax liabilities under an IRS Private Letter Ruling that stated.....

Retirement withholdings are not wages for purposes of the FICA, provided that they were not picked up pursuant to a salary reduction agreement.

In 1998, the Tenth Circuit of the United States Court of Appeals ruled in “Public Employees Retirement Board v. Shalala that reducing the gross wages by the pension withholdings to calculate FICA taxes is a salary reduction agreement.

This is how Kentucky calculates their taxable FICA wages.

In another Court of Appeals case,

The opposite of a salary reduction agreement was described as a salary supplement agreement,

The employer would pay the employees pension contributions in addition to their gross wages.

Since the Tenth Circuit Court decision,

The IRS has been addressing these private letter rulings with each respective state.

It is our understanding that Kentucky is the final state to be addressed.

In addressing Kentucky's underpayment.....

The IRS required that Kentucky prepare a reasonable plan to change the treatment of the pension contributions.....

And, to bring the state into compliance for calculating FICA and Medicare tax liabilities effective December 31, 2015.

Through a series of negotiations,

The Commonwealth resolved this dispute by:

- 1) contractually being assured that no past liability would be owed by government agencies
- 2) and second, that the new calculation would be effective January 1, 2017

This would give agencies sufficient time to:

- 1) plan for budgeting purposes,
- 2) make changes to payroll systems,
- 3) and, communicate effectively with all impacted employers and employees.

Under a Memorandum of Agreement effective January 1, 2017, taxable FICA wages will include the employees' pension contributions.

But, the employer will continue to deduct Cafeteria Plan expenditures,
(i.e. health insurance, flex spending accounts).

This settlement affects all governmental employers in the Commonwealth of Kentucky.

- . Executive, Legislative and Judicial Branches of state government,
- . Eight universities and KCTS
- . 1,471 counties, city and local school districts.

The state estimates that for State Government Agencies, the additional annual cost will be approximately \$5.7 million.

Both the governmental employers and their employees will each have to pay the increased amount.

Examples of the increased cost are in the attached handouts.

**Note that for employees who participate in Social Security....
the additional contributions will result in increased Social
Security benefits upon retirement.**

**The salary portion of the employee pension withholdings.....
continue to be exempt from Income Tax.**

IRS MEMORANDUM OF AGREEMENT
EXAMPLE CALCULATION FOR COST TO EMPLOYEES and EMPLOYERS PER PAY PERIOD
Beginning January 1, 2017

Rev. 8-11-2015

ASSUMPTIONS:

Average Annual Salary = \$40,500
Monthly Salary = \$3,375
Semi-monthly = \$1,687.50

FICA = 6.2%
*Medicare = 1.45%

	KY RET SYSTEM KERS/CERS		KY RET SYSTEM-HAZARDOUS KERS/CERS/KSP		JUDICIAL & LEGISLATIVE RET SYSTEM		OTHER RETIREMENT SYSTEMS TIAA-CREF UNIVERSITIES KTRS Regional Univ		MEDICARE ONLY TEACHERS NO SOCIAL SEC COVG	
Pension Contribution Percentage^	Tier 1=5%	Tiers 2 & 3 = 6%	Tier 1=8%	Tiers 2 & 3 = 9%	Tier 1=5%	Tier 2=6%	5.00%	8.185%	12.855%	5.0%
CURRENT CALCULATION:										
Semi-monthly Gross Pay	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50
Less Retirement Contribution	84.38	101.25	135.00	151.88	84.38	101.25	84.38	138.12	216.93	84.38
Base Wages for FICA	1,603.13	1,586.25	1,552.50	1,535.63	1,603.13	1,586.25	1,603.13	1,549.38	1,470.57	1,603.13
FICA tax	99.39	98.35	96.26	95.21	99.39	98.35	99.39	96.06		
Medicare tax	23.25	23.00	22.51	22.27	23.25	23.00	23.25	22.47	21.32	23.25
Total FICA & Medicaid per period	122.64	121.35	118.77	117.48	122.64	121.35	122.64	118.53	21.32	23.25
NEW CALCULATION:										
Semi-monthly Gross Pay = Base wages for FICA	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50	1,687.50
FICA tax	104.63	104.63	104.63	104.63	104.63	104.63	104.63	104.63		
Medicare tax	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47	24.47
Total FICA & Medicaid per pay period	129.09	129.09	129.09	129.09	129.09	129.09	129.09	129.09	24.47	24.47
Total withholding increase Per Pay Period (agency & employee)	6.45	7.75	10.33	11.62	6.45	7.75	6.45	10.57	3.15	1.22

* Everyone hired after 1986 is federally mandated to pay Medicare.

^ Employee contribution percentages vary based on system, classification, tier and date-of-hire.